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Supreme Court, U.S.
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In The

Supreme Court of the United States

DENNIS HECKER, JONNA DUANE,
AND JANICE RIGGINS,

Petitioners,

v.

DEERE & COMPANY,

Respondent.

On Petition For A Writ Of Certiorari To The United States Court Of Appeals For The Seventh Circuit

BRIEF FOR MATTHEW D. HUTCHESON AND ROBERT BROOKS HAMILTON AS *AMICI CURIAE* IN SUPPORT OF PETITIONERS

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INTEREST OF *AMICI CURIAE*[1]

Matthew D. Hutcheson and Brooks Hamilton are professional independent fiduciaries, and are well known and respected advocates of retirement plan participants. As independent fiduciaries, they are appointed by employers to be the principal decision makers for ERISA plans. They are thus representative of prudent men who have firsthand practical knowledge of what it means to expertly conduct an enterprise of like character with like aims under prevailing circumstances (see 29 U.S.C. § 1004, 404(a)(1)(B)).

This brief is supported by Fiduciary360 (fi360),[2] the Centre for Fiduciary Excellence (CEFEX),[3] and the Committee for the Fiduciary Standard.[4]

Fiduciary360 (fi360) provides training, Web-based tools, and resources for investment fiduciaries. The mission of fi360 is to promote a culture of fiduciary responsibility and improve the decision

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[1] No counsel for a party authored this brief in whole or in part, and no person or entity other than *amici curiae* and their counsel made a monetary contribution to fund its preparation or submission. Counsel for Petitioners filed a letter with the Clerk granting blanket consent to the filing of *amicus* briefs, and a letter reflecting the consent of Respondent to the filing of this brief has been filed with the Clerk. The parties were notified ten days prior to the due date of this brief of the intention to file.

[2] www.fi360.com

[3] www.cefex.org

[4] www.thefiduciarystandard.org

making of those who manage money on behalf of others.

The Centre for Fiduciary Excellence, LLC is an independent certification organization. CEFEX works closely with industry experts to provide comprehensive assessment programs to improve the fiduciary practices of investment stewards, advisors, recordkeepers, service providers and managers.

The Committee for the Fiduciary Standard is a nonpartisan membership organization of over 600 investment professionals whose mission is to preserve the authentic fiduciary standard in any legislation and rulemaking.

These three organizations provide education, certification, and other services to over 5,000 fiduciary professionals who in turn serve millions of retirement plan participants.

SUMMARY OF ARGUMENT

Fiduciaries are held to a standard of knowledge and behavior applied to those familiar with such matters, otherwise known as "experts." Thus, within the 401(k) industry, the fiduciary standard is often referred to as the "prudent expert rule." When coupled with a duty of loyalty, the prudent expert standard becomes the "highest duty known to the law." *Donovan v. Bierwirth*, 680 F.2d 263, 272 (2d Cir. 1982).

As experts familiar with the prevailing circumstances surrounding the management of a pension benefit program defined under ERISA (29 U.S.C. § 1002, 3(2)(A)), *amici* respectfully submit to the Court that the lower courts have misinterpreted the matter now before this Court as a "mutual fund" pricing issue. The lower courts erred in that interpretation.

The matter before the Court is simple; plan fiduciaries are required to act as a prudent expert within the context of managing a $4 billion retirement plan with 17,000 participants. Participants were unnecessarily harmed because defendants failed to understand and then act upon their most fundamental, fiduciary duty.

The defendants permitted the participants to be harmed by turning a blind eye toward competitive alternatives which could have ensured that only reasonable plan costs were incurred. The defendants are held to the prudent expert standard. As prudent experts, the defendants failed to meet the required standard.

ARGUMENT

The highest standard known to the law carries with it a commensurate sensitivity to the specific needs of a given retirement plan's participants and beneficiaries. Participants and beneficiaries rely on fiduciaries with an expectation they will be protected

from unnecessary risks, costs, and harm. Participants and beneficiaries are therefore vulnerable to the actions – or inactions – of those in a position of trust, such as a named fiduciary or trustee.[5] ERISA contemplates that fiduciaries should and will exert a high degree of diligence by periodically investigating investment and service alternatives available to a plan. The larger the plan is, the greater the economic advantage a fiduciary may capture for the exclusive benefit of participants. In other words, larger plans have greater bargaining power that can be brought to bear for the participant's benefit.

Failing to understand that economic advantages were available, and then leaving those advantages un-captured due to insufficient application of care, skill, effort, etc., is fundamentally a disloyal act, and damages the retirement saving interests of participants and beneficiaries. Thus, the defendants failed to properly serve the specific purpose for which funds were entrusted to them.

Congress intended ERISA to require fiduciaries to exert careful and skillful effort on behalf of participants and beneficiaries for a reason; because participants and beneficiaries are both reliant on fiduciaries, and vulnerable to their actions. A broad

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[5] Journal of Pension Benefits; Spring 2009 401(k) Investments Column – A New Look at Fiduciary Responsibility. Pages 53-56. See also October 1, 2009 Congressional Statement by Matthew D. Hutcheson; United States House of Representatives, Committee on Ways and Means.

market "suitability" standard (a lesser, non-fiduciary standard) is not sufficient to determine reasonableness and fairness of plan costs and satisfy associated ERISA obligations.[6] If market forces alone are deemed sufficient to determine the fairness of fees and costs fiduciaries would serve no meaningful purpose in this regard. Yet, that is clearly not what Congress intended. Congress understood that participants and beneficiaries would need the protections of a diligent fiduciary. Accordingly, ERISA requires at least one named fiduciary [ERISA § 402(a)] to be appointed to control and manage administration and operation of a plan, which includes the obligation to control and account for plan expenses. The high fiduciary standard of care and the appointment of fiduciaries under ERISA are inextricably connected.

Thus, while a suitability or open market argument might be acceptable in normal day-to-day business activities, it is not sufficient for a 401(k) or other employee benefit plan subject to ERISA's strict fiduciary requirements.

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[6] FINRA, NASD Manual: Rule 2310: Recommendations to Customers (suitability), http://finra.complinet.com/finra/display/display.html?rbid=1189&element_id=1159000466 (last visited Nov. 12, 2009). Suitability, or the so-called "Know Your Client Rule," is intended to ensure practitioners broadly understand client's objectives with their money in each of their accounts; ***it is not a fiduciary standard***. See Investor Glossary, Know Your Client, http://www.investorglossary.com/know-your-client.htm (last visited Nov. 12, 2009).

> Many forms of conduct, permissible in a workaday world for those acting at arm's length, are forbidden to those bound by fiduciary ties. A trustee is held to something stricter than the morals of the market place. Not honesty alone, but the punctilio of honor the most sensitive, is then the standard of behavior. As to this there has developed a tradition that is unbending and inveterate. Uncompromising rigidity has been the attitude of courts of equity when petitioned to undermine the rule of undivided loyalty by the 'disintegrating erosion' of particular exceptions. Only thus has the level of conduct for fiduciaries been kept at a level higher than that trodden by the crowd. *Meinhard v. Salmon, 249 N.Y. 458, 464, 164 N.E. 545, 546 (1928).* (Cardozo, Ch. J.).

Prudent fiduciaries are required to pursue the most reasonably efficient course available to secure retirement income for participants and beneficiaries, as contemplated under the Employee Retirement Income Security Act. Most importantly, it is incumbent upon a fiduciary to examine lower-cost alternatives to mutual funds, alternative mutual fund share classes, or even exchange traded funds and collective trust funds. Such an examination is an obviously prudent step – common to anyone who comparison shops at the local grocery store for a $4.00 item – but ignored by the defendants who were charged with a $4 billion responsibility to care for the retirement income security of 17,000 employees. The

course we would have taken is very different than the course taken by the defendants.

I. Evaluating investment alternatives critical to a prudent process.

Retail mutual funds have built in subsidies, or "gross-ups" to the fund's management fee. In other words, the fund management fee is artificially inflated to pay for something other than managing the fund. The industry calls those gross-ups or subsidies "revenue sharing." Revenue sharing may be used to pay for sales and marketing efforts, paying third party service providers, or compensating other divisions of the fund management company – such as in this instance.

Fees could easily be charged explicitly for such services, but the industry has widely endeavored to embed these subsidies in a fund's management fee to create an economic illusion that certain services cost less, or even cost nothing. However, the economic illusion, as problematic as it is to the fulfillment of fiduciary duty is only part of the problem. The greater issue is that *revenue shared is not necessarily revenue earned*, and that because of its embedded nature within a fund, the crossover point from reasonable to excessive will be murky if a fiduciary is not diligent in his or her duties – but a fiduciary is obligated not to permit that to happen unknowingly. Therefore, certain 401(k) business models and certain fund classes, when coupled together, pose a

significant challenge for fiduciaries if they are not paying attention.

II. Revenue sharing – subject to its own competitive sphere.

Because revenue sharing is unrelated to the activity of pursuing a return on investment, its very nature is extraneous. Those extraneous fees are subject to their own separate competitive forces. Those services paid for by extraneous fees are offered by a wide variety of competitors and are usually charged (or at least compared) on an hourly or per capita basis. In other words, the revenue sharing amounts are evaluated within a competitive framework that is separate from the investment or mutual fund industry. Revenue sharing is universally viewed as an entirely separate type of cost by those professionals familiar with such matters. The excess revenue (i.e. revenue generated by the fund but not earned by service providers) is frequently recaptured and credited back to participants as an industry best practice when revenue sharing cannot be avoided.

When revenue sharing is viewed in proper context, within its correct competitive realm, it is simple to assess the value of those fees and determine whether incurring their costs serves the best interests of participants.

For example, a leading provider of retirement plan services for large employers (www.milliman.com) would charge approximately $1,195,000[7] for a plan with 17,000 active participants.[8] It is estimated that defendants permitted at least $2,362,703 to be charged for the same general services.[9] If a competitive environment truly existed within this specific realm and context, a disparity of nearly 100% could not reasonably exist.[10] From first-hand knowledge of

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[7] Service fee of $70.30 per participant quoted by Genevieve B. Sedgwick, Senior Defined Contribution Consultant, Milliman, Inc.

[8] Number of employees stated on Deere & Company most recently available form 5500 filed with the Employee Benefit Security Administration as reported by www.BrightScope.com.

[9] Data by www.BrightScope.com. BrightScope renders no opinion about the meaning of the data, and bears no bias toward either party in the matter. All data interpretations and conclusions are that of the *amici*.

[10] Fund names and balances were pulled from Deere's 11-K filed with the SEC and accurate as of 10/31/2009. Share classes were assumed to be the lowest cost share class available to retail investors. In many cases this is the "Spartan" or "Advantage" share class. Fidelity has recently begun offering a "K Share" class to 401(k) investors but these shares were not available during the contemplated period. Sub-TA fees are the fees that these funds would pay to a recordkeeper through an external trust platform. Fidelity does not disclose its internal revenue sharing. Estimated Sub-TA information is only available for funds subject to the Investment Adviser Act of 1940. However some of the other funds (i.e. The Blended Interest Fund, Pyramis Commingled Pool etc.) may also pay revenue sharing. A revenue share of 10 basis points was assumed for the non-Fidelity funds on the menu. Revenue sharing is at least $2,362,703 (at least 10 basis points or .1% of plan assets, or

(Continued on following page)

amici, the excess revenue sharing fee could actually be as high as $7,848,000 annually.[11]

A prudent expert familiar with such matters will view the difference between the two fees as excessive and unreasonable, and could not overlook an unanswered concern. The precise value of services paid for by such fees should be the focus of a proper and thoughtful fiduciary analysis; an exertion of effort, proper questions, going out to bid, exploring available alternatives, etc. Suffice it to say that the large disparity reveals excess fees. Failure to exert a true fiduciary effort that leads to the incurring of unnecessary fees clearly violates the "reasonableness" standard required under ERISA. 29 U.S.C. § 1004, 404(a)(ii).

Further, there is a point at which previously reasonable fees or expenses can become unreasonable. Consider the following:

> For example, if a recordkeeper is receiving $50,000 in revenue sharing, and if a

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roughly $140 per participant per year). It is believed that an additional revenue sharing of up to .3% or 30 basis points could be charged and kept by service provider totaling .4% or 40 basis points.

[11] Experience and analysis of *amici* suggest that as much as .4% of plan assets, or $9,042,876 ($2,260,719,000 multiplied by .4%) could be extracted from participant accounts for a service that costs $1,195,000 on the open market. The .4% includes both 12(b)1 and Sub-Transfer Agent fees. $9,042,876 – $1,195,000 = $7,847,876)

> reasonable charge for its services is $50,000 – the same amount – there is no conflict. However, if the plan grows with time and the revenue sharing grows to $85,000, but a reasonable charge only increases to $60,000, the fees have become excessive. At that point, the responsible fiduciaries have three jobs: to know about the amount of the revenue sharing, to know the reasonable cost of the recordkeeper's services, and to reclaim the difference for the plan and the participants.[12]

That is an accurate description of the issue before the Court. At some point, the revenue sharing in the Deere 401(k) plan exceeded a reasonable level and the fiduciaries did nothing to identify when that moment might occur or prevent it when it did. Their failure to understand and to act breached their fiduciary duty to participants and beneficiaries.

III. Fiduciaries must appreciate their high duty.

What fiduciaries do, or do not do, affects many lives. Fiduciaries must be reminded of their high duty, and be held accountable for fulfilling that duty.

According to estimates from the Employee Benefits Research Institute, on June 30, 2009 (see

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[12] ["Revenue Sharing: What is it?" http://www.reish.com/publications/article_detail.cfm?ARTICLEID=790]

http://www.ebri.org/publications/ib/index.cfm?fa=ibDisp&content_id=4326) the median 401(k) held by someone on the verge of retirement age was $69,000. What does that number really mean? At the typical financial planners' recommended withdrawal rate of 4% a year, it means that the median retiree can count on a lifetime retirement income of Social Security plus $233 a month from his 401(k). The 401(k) is not working as well as it should, and excessive plan fees and expenses coupled with *fiduciary indifference* are two primary reasons.

The issuance of this Writ will enable the Supreme Court of the United States to give notice regarding the duty and responsibility of an ERISA fiduciary, respecting not only the initial nature and transparency of all transactions including economic costs of every nature, but also the ongoing monitoring and reasonableness of plan fees and expenses, *to act solely for the benefit of plan participants and to use the care that a prudent man acting in a like capacity and familiar with such matters would use.*

IV. The fiduciary standard must be enforced.

It is not necessary that ERISA command fiduciaries in all things; rather, fiduciaries must be actively engaged in properly discharging their duties even in the absence of specific rules or guidance. Therein lies the very reason fiduciary duty is the highest known to the law. Fulfilling fiduciary duty

requires judgment, discretion, and careful consideration.

The lower Court ruled that a *lower* standard of care or duty, if one can call it that, was adequate. We believe that the Court failed to understand that its ruling effectively nullified the need for ongoing fiduciary oversight, and eviscerates what Congress originally contemplated. In very clear and simple terms, the lower Court held that a *"so-so"* behavior with *"so-so"* results (at best) is the standard fiduciaries must meet, not the highest standard known to the law.

The true question of prudence here is not how many funds were offered on the plan's menu, nor whether or not these funds were also offered to the public, but rather whether a prudent investor *"acting in a like capacity and familiar with such matters"* would have selected the same retail mutual funds in the core funds, as well as the brokerage window, as those selected by the Deere fiduciaries.

Further, *"in a like capacity"* does not mean that the defendant fiduciaries must think like a prudent individual would think *"in the general public"* but rather they must think and act like a prudent investor controlling the design, administration, and oversight of a $4 billion investment plan menu.

CONCLUSION

As stated earlier, ERISA requires that a fiduciary shall discharge his duties with respect to a plan solely in the interest of the participants and beneficiaries and with the care, skill, prudence, and diligence under the circumstances then prevailing. That requires continuing effort and attentiveness.

If the matter before the Court is only about the competitiveness of mutual funds, and if the Court upholds the lower Courts' decision, then the fiduciary standard of care is eviscerated. In other words, if the lower Court's decision is upheld, plan decision makers will be encouraged to simply place a large number of funds before participants and then hide – *for their own benefit, not the participants'* – behind 404(c), under the presumption that none of those funds can have excessive fees because a competitive market will not permit it. The interests of participants and beneficiaries will be compromised and the integrity and trustworthiness of the 401(k) system will be undermined.

In such a world, fiduciaries would not need to review the funds for economic appropriateness given the size and objectives of the plan or the needs of participants. And in that world, fiduciaries would need to exercise no care, skill, prudence, or diligence. They could safely ignore prevailing circumstances regarding other types of financial instruments which may be more efficient than mutual funds, such as collective trust funds or exchange traded funds. And in such a

world, fiduciaries could conveniently turn a blind eye toward the bargaining power of large plans – all to the detriment of participants whose sole interests they are charged to protect.

Thus, the lower Court rulings weaken the intent of Congress to require that fiduciaries engage in periodic thoughtful, deliberate investigation of all alternatives. That requires careful and skillful evaluation of how costs impact a participant's long-term retirement income security – the core objective of ERISA.

Respectfully submitted,

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